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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 908

THOMAS McCAFFREY, JR. and LILLIAN S. McCAFFREY,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

The argument for the United States in opposition to the Petition is as follows:

1. The two properties involved are not similar or related "in service or use *as property*" and that the taxpayer does not contend that they are.

2. The functional test requires a close identity of purpose and use as between the two properties involved.

3. That *Winter Realty & Construction Co. v. Commissioner*, 149 F. 2d 567, (C. A. 2) did not present on appeal the question as to the similarity of the converted and replacement properties.

4. That this Court's decisions in *Woolford Realty Co. v. Rose*, 286 U. S. 319, and *McWilliams v. Commissioner*, 331 U. S. 694, did not involve Section 112(f) and that the Petitioner did not attempt to explain the asserted conflict.

5. That the decision in *Steuart Brothers, Inc. v. Commissioner*, 261 F. 2d 580 (C. A. 4) did not eliminate consideration of the functional test.

(a) That the decision in *Steuart Brothers, Inc.* rested in large part on the conclusion that the new property was "of the same general character" or "same general class' as the old; and further,

(b) That *Steuart Brothers, Inc.* does not stand for the proposition that the mere reinvestment of condemnation proceeds is "*per se* sufficient to satisfy the service or use requirement of Section 112(f)."

6. The question is not important, is essentially factual and has been greatly minimized by the 1958 legislation.

Reply to Respondent's Argument That The Two Properties Involved Are Not Similar or Related "In Service or Use as Property" and That Taxpayer Does Not Contend That They Are.

The "use" of the property must be viewed from the taxpayer's perspective not the tenant's. *Davis Regulator Co.*, 36 B. T. A. 437; *Winter Realty & Construction Co., supra; Gaynor News Co.*, 22 T. C. 1172.

This Court has said that tax statutes are concerned with the taxpayer "why's" and "how's". See analysis of this Court's decisions in *Woolford's Realty Co. v. Rose*, 286 U. S. 319 and *McWilliams v. Commissioner*, 331 U. S. 694, *infra*. This Court has often held the substance of a transaction rather than its form is the determinative criterion. See *Griffiths v. Commissioner*, 308 U. S. 355; *Gregory v. Helvering*, 293 U. S. 465 and *Minnesota Tea Co. v. Helvering*, 302 U. S. 609. Respondent contends that the statute is concerned only with "similar" property and disregards the statute which also deals with "property related in service or use."

The section of the statute before this Court is a "relief" section.

"It is frequently said that relief or remedial provisions must be liberally construed to effectuate the objectives sought." (See *Merten's Law of Federal Taxation*, Volume 1, Paragraph 4.09 and the cases cited therein.)

If there is any uncertainty in the Statute or the Regulations, the Petitioner contends that where the issue before the Court for decision is the application of a "relief provision," the Court could well rely on the "century and a half old ruling" for the construction of tax statutes announced by the Supreme Court of the United States in *Gould v. Gould*, 245 U. S. 151, where the Supreme Court said:

> "In the interpretation of statutes levying taxes, it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters not specifically pointed out. *In case of doubt they will be construed most strongly against the Government and in favor of the citizen.*" (Emphasis ours.)

Petitioner has never contened that the properties were similar physically. Many decisions hold that such requirement need not be met. See *The Columbus Die, Tool & Machine Co.*, P. 52312 P. H. Memo T. C.; *Davis Co.*, 6 BTA 281 Rev. Rul 54—569, 1954—2 Cum. Bull 144; *Cotton Concentration Co.*, 4 BTA 121, *Hawking Glass Co. v. Miller*, 5 Fed. Supp. 355; and *Gaynor News Co., Inc., supra.*

Reply to Respondent's Argument That The Functional Test Requires a Close Identity of Purpose and Use as Between the Two Properties Involved.

The cases of *Cotton Concentration Co. v. Commissioner*, 4 B. T. A. 121; *Flaxlinum Insulating Co. v. Commissioner*, 5 B. T. A. 676; *Haberland v. Commissioner*, 25 B. T. A. 1370; *Buckhardt v. Commissioner*, 32 B. T. A. 1272; *Kimbell-Diamond Milling Co. v. Commissioner*, 10 T. C. 7; and *Masillon-Cleveland-Akron Co. v. Commissioner*, 15 T. C. 79, are clearly distinguishable from the present case as "in these cases the use of the property by the taxpayer itself before the involuntary conversion took place was compared with the use of the new property by the taxpayer itself thereafter." The U. S. Court of Appeals for the Fourth Circuit, in *Steuart Brothers, Inc.* (Petitioner's Appendix B, page 46), so stated and the Petitioner agrees with that position.

The functional test was applied in the *Lynchburg National Bank & Trust Co. v. Commissioner*, 208 F. 2d 757, case only because "before the fire and the demolition of the original building, the property served as an investment of the bank and was used by the bank's tenants for a shoe store and a restaurant, while afterwards it was used by the bank itself as its place of business." See *Steuart Brothers,*

Inc., supra, where the Court further stated: "the present case (meaning Steuart) does not present such a dissimilarity." That case was decided on the taxpayer's use before and after as compared with the tenant's use. In the present case the taxpayer's use was rental both before and after the conversion.

The *M. J. Calbeck Corp.* case, 36 B. T. A. 452, rather than supporting the Commissioner of Internal Revenue's position sustains the taxpayer's. We quote from *Steuart Brothers* as follows:

> "Prior decisions of the Tax Court have adopted this view. In *M. J. Calbeck Corp.*, 36 B. T. A. 452 (CCH Dec. 9740), the taxpayer owned an opera house which had been remodeled to provided two stores on the ground floor and a moving picture theatre above. After a fire which destroyed the building the taxpayer leased the property and agreed to construct a new building to be used by the tenant for a department store. The decision went against the taxpayer because the replacement of the investment was not made 'forthwith' as required by the provisions of the section as it appeared in the Internal Revenue Act of 1932. But in passing on the comparative uses of the property the Tax Court said (page 454):
>
> > " 'We think it beyond serious question that the old and the new buildings were "similar or related in service or use" within the meaning of the statute. Both were business properties; in the old, part of the income was from rents from stores on the ground floor and part from the operation of a motion picture theater; in the new, the income was from rents from ground floor stores. There were differences in the type of construction and the height and depth of the buildings, but the statute does not require exact physical duplication. *Cotton Concentration Co.*, 4 B. T. A. 121 (CCH Dec. 1457).' "

The *Edmond Weil, Inc. v. Commissioner*, 150 F. 2d 950, case was decided on the basis that there was no involuntary

conversion. The dicta of that case sustains the taxpayer's position because an investment in "stock" of a corporation is not similar to a "loan" to a partnership. The lack of similarity of corporate stock and a loan to a partnership is so apparent no comparisons are necessary.

The taxpayer in *Collins v. Commissioner*, 29 T. C. 67, operated a poultry business. After the condemnation Collins acquired (1) rental property consisting of two houses and furniture, and (2) a partnership interest in a gasoline filling station. The use of the property by the "taxpayer" before and after the involuntary conversion again controlled.

Reply to Respondent's Argument That Winter Realty & Construction Co. v. Commissioner, 149 F. 2d 567, (C. A. 2) Did Not Present on Appeal the Question as to the Similarity of the Converted and Replacement Properties.

We quote from the Opinion of the Circuit Court of Appeals for the Second Circuit, as follows:

> "Both parties appeal from an order of the Tax Court which assessed a deficiency against the taxpayer * * *"

and further,

> "The first question is as to how much of an award granted to the taxpayer upon condemnation of certain real property was 'expended in the acquisition of other property similar * * * to the property' condemned, * * *" (See Appendix C to Petitioner's Petition, page 48)

and further,

> "The Tax Court held that the attempt to set up a 'replacement fund' failed; that the mortgages were not 'similar property or property related in service or use'; but it allowed the sum of $51,116.25 invested in

real estate in 1936 as an exemption because it had been invested in that year in 'similar property or property related in service or use.' This last ruling is the basis of the Commissioner's appeal; the taxpayer appeals from the rulings against it." (See Appendix C to Petitioner's Petition, page 51)

We interpret the above quotation to mean that the Commissioner appealed from, *inter alia*, the Tax Court decision that the taxpayer invested in "similar property or property related in service or use. The comparision of the old property and the new property is detailed in *Steuart Brothers, Inc.*, in the Petition, Appendix B, pages 45 and 46.

Reply to Respondent's Argument That This Court's Decisions in Woolford Realty Co. v. Rose, 286 U. S. 319, and McWilliams v. Commissioner, 331 U. S. 694, Did Not Involve Section 112(f) and That the Petitioner Did Not Attempt to Explain the Asserted Conflict.

Petitioner concedes that those decisions did not involve Section 112 (f). They were not relied upon as interpreting that Section.

They were cited as the ruling of this Court on the question of "Construction of Tax Statutes."

In *Woolford Realty Co.* (*supra*) and in *McWilliams* (*supra*) this Court gave guidance to taxpayers on the subject of how tax statutes must be construed.

This Court in *Woolford Realty Co.* construed a statutory provision dealing with "loss-carry-forward-deductions" and their use in the computation of the net income of affiliated corporations filing consolidated returns. The literal

words of the statute referred to "the taxpayer" having the right to deduct "loss-carry-forwards." The consolidated return as filed deducted prior years' "loss-carry-forwards" of one of the corporations from the net income of the other affiliated corporation.

The literal words of the statue allowed "the taxpayer" the right to deduct "loss-carry-forwards." The Petitioner contended that the literal words "the taxpayer" was authority for its contention that the affiliated group became "the taxpayer" and hence could deduct loss-carry-forwards of either member of the affiliated group. Such a contention represents the "objective" approach to statutory construction based upon the literal words of the statute.

This Court disagreed with the Petitioner and held that the statute must be construed "subjectively"; that it must be interpreted with relation to the activities of the taxpayer whose tax liability is being determined. This is the "subjective" approach.

This same result obtained in *McWilliams*, an inter family loss case, where losses between members of a family were disallowed. There both husband and wife sustained losses on sale of separately owned securities which were sold concurrently through brokers on a national stock exchange and repurchase made through like sources and where it was agreed that there was no specific identity between the shares sold and purchased by the husband and wife. The statute literally referred to losses between "members" of a "family" sustained "directly or indirectly."

An objective view of the facts and the law supported the taxpayers' contention that the loss must be recognized. This Court ignored the formalities of the transaction and ap-

plied the statute "subjectively" looking at the effect of the transactions on the husband and wife as individuals.

Both the *Woolford Realty* case and the *McWilliams* cases stand for the following principle:

> "The literal meaning of words (the 'objective' test) cannot be insisted upon in resisting a tax provision so as to defeat its purpose but should be reasonably construed with reference to the subject matter and the general course of the business involved (the 'subjective' test)." Matter in parentheses is ours. See *Mertens "Law of Federal Income Taxation"*, Section 3.04 footnote 50.

Reply to Respondent's Argument That The Decision in Steuart Brothers, Inc. v. Commissioner, 261 F. 2d 580 (C. A. 4) Did Not Eliminate Consideration of the Functional Test.

(a) That the Decision in Steuart Brothers, Inc. Rested in Large Part on the Conclusion That the New Property was "of the Same General Character" or "Same General Class" as the Old; and Further,

(b) That Steuart Brothers, Inc. Does Not Stand for the Proposition That the Mere Reinvestment of Condemnation Proceeds is "Per Se Sufficient to Satisfy the Service or Use Requirement of Section 112(f)."

We contend that the United States Court of Appeals for the Fourth Circuit in *Steuart Bros. Inc.* did eliminate consideration of the functional test as approved by it previously in *Lynchburg National Bank & Trust Co. v. Commissioner, supra.* The functional test was eliminated from con-

sideration on the specific grounds that the *Lynchburg case* was decided by the same Court on the basis that the old Lynchburg Bank property was investment property while the new property was used as a bank's place of business. We think this is proof enough that that Court intended to eliminate the functional test factor in a case involving an investor whose rental income property was condemned and who reinvested in other rental real estate.

On the question of the weight to be given to the Court's language "same general character" and "same general class" we comment as follows:

The question to be decided as stated by the Court was whether the taxpayer "*invested*" in real property of the "*same general character.*"

The Court's conclusion was that the (old) real estate was held by it for investment purposes the proceeds were • • • reinvested in real estate of the "same *general class.*"

We must harmonize the Court's statement of the question and its conclusion and when we do so it is apparent the Court employed the terms "character" and "class" interchangeably.

Further, in *Steuart Bros.* there were no "old properties" but only an agreement to construct and lease a warehouse, and a building having offices, warehouse and storage space. The new properties were leased as an auto showroom, repair shop, garage and service station.

Respondent contends that the Court's language of "same general character—same general class" means that the old and new properties in *Steuart Bros.* were "similar" and hence this is a sufficient explanation of the Court's decision. We think it obvious that the functions of an office,

warehouse, storage building are not the same as auto showroom, repair shop, garage and service station and we believe the Court could not have believed that they were and that its decision does not rest on the "character" or "class" of the old and new properties.

Further, if any weight need be given to Respondent's argument as to the functional use of the old and new properties in the present case, he must admit that both properties had the same "function" *i.e.* both were for "storage"—the old to store automobiles—the new to store materials of the F. C. D. A.

We contend that that Steuart Bros. does stand for the proposition that the mere reinvestment of the condemnation proceeds is "*per se*" sufficient to satisfy the requirement of Section 112(f). But even assuming *arguendo* that it does not stand for such a proposition, Petitioner contends it meets the similarity test since the proceeds of "industrial" rental real estate were reinvested in "industrial" rental real estate.

Reply to Respondent's Argument That The Question is Not Important, is Essentially Factual and has Been Greatly Minimized by the 1958 Legislation.

The Petition, at pages 20, 21, 22 and 23 indicates that the basic issue in this case is much broader than the 1958 law change and does not for the future eliminate confusion in relation to the replacement of property other than the rental real estate in the voluntary conversion situation.

Conclusion

The Conclusion of this, the Petitioner's Reply Brief, is that its Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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June, 1960.